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Chapter 1

INTRODUCTION: RISKS & RETURNS

The question of whether or not art is an asset is a source of wide-ranging debate, which often encapsulates much of the art world's hidden agendas.

In recent years, there have broadly been two opposing camps. On one side have been the financially minded professionals, whose sophisticated models and technical ambitions have encouraged the 'art as a working investment' thesis. The other side, largely made up of the art-dealing community, has overtly spurned such a rigorous and analytical way of looking at their wares. A variety of reasons is offered, primarily that art's unique, aesthetic and intangible qualities cannot be mapped onto a share-price graph and that doing so denudes it of all that makes it great.

Within these polarised opinions are, of course, many grey areas. Among the dealing and auction-house community, there is an acceptance that, while it might be more de rigueur never to mention money in conjunction with art, its changing value is what keeps their businesses alive.

It is important to start with the broad acceptance that all art in the market *is* an asset. Art is something for which people are willing to pay money and that they expect to be able to resell, regardless of the level or whether or not they intend to do so. It is the source of income for several intermediaries – there are an estimated 23,000 auction houses globally, at all levels of the market (accounting for around 50% of trades) and an estimated 375,000 dealers in the art world[1] – not to mention the artists themselves. An industry has grown around art, and people are willing to pay for museum exhibitions, books, art journals and a range of art-related advisory services. Irrespective of whether or not it should be, art is treated as something of value.

This has extended to those with investment in mind. The growing attraction of art to those known as 'ultra-high-net-worth individuals'

(with investible assets of over $30m) and their poorer cousins, the 'high-net-worth individuals' ($1m-plus), has been driving the art-as-an-asset market, particularly through the years building up to the market's boom in 2007. The clout of the private banks that serve the wealthy has exacerbated the trend.

The breakdown of top-down global asset allocation is a relevant context for putting each discussed market in this book into perspective. According to the 2013 Capgemini and RBC Wealth Management 'World wealth report', for the first quarter of that year, the greatest proportion of high-net-worth-individual wealth was kept in cash (28.2%), followed by public equities (26.1%; see Chapter 2), real estate (property, excluding primary residence, 20%; see Chapter 5) and fixed income (generally debt, including bonds, 15.7%). The remaining 10.1% (a declining but still significant figure) was reserved for alternative assets, which include commodities (such as gold; see Chapter 3), private equity (see Chapter 6), structured products (such as asset-backed securities, credit derivatives), hedge funds, derivatives and foreign currency.[2]

While it does not quantify this effect, a separate report by the property group Knight Frank finds that private investors with over $30m to invest at the end of 2012 had an average 4% of their money in such goods, of which, at the end of 2012, the greatest proportion (19%) was in fine art.[3] Although Knight Frank sees this as a relatively low amount (just 19% of just 4%), it is significant for the art market. With the total amount of 2012 global high-net-worth-individual wealth estimated at $26tn (and growing), this means that the average amount in art is $197bn, over three times the size of the market's annual turnover.

Meanwhile, the wealthy themselves are also growing in number and resources, with the much-documented 'rich are getting richer' trend, even during turbulent global economic times, prevailing. It seems that, regardless of the returns that may or may not come from such assets, high-net-worth individuals are choosing to put (or at least keep) a significant amount of their wealth in their passions, *instead* of in shares and property, for example. Capgemini identifies this as the

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'substitute' effect – and it is arguably at a level that is disproportionate to their alternatives-to-the-alternatives status.

IS ART A *GOOD* ASSET?

That art is an asset, and an increasingly popular one, does not mean, however, that it is a particularly good place to invest. Even those with a grounding in finance have gradually come down on the side of art *not* being a particularly profitable area, albeit for different stated reasons than offered by their art-dealer counterparts. After a good decade of trying to assess and predict art's returns, several experts hit the wall. It seems that discussion shifted from art being nothing but a financial asset to anything but a financial asset.

The purpose of this book is to assess whether or not art is a *good* asset, which can only really be determined in relation to other available investments. Further, this needs to take into account not just the relative returns on art, but also its relative risks.

Most analyses of the art market to date concentrate on the relative returns, almost regardless of risk. All available research on the broad market suggests that the average compound return on all segments of investment-grade art, taken together and held for between five and ten years, is around 4%. Relatively speaking, this is pretty low – it is considerably less than for gold, wine and both public and private equity.

The evidence is, however, that – in a good year or for certain artists or works – art can produce a higher rate of return than, say, the US stock markets. When the musician Eric Clapton sold his Gerhard Richter work, *Abstraktes Bild (809-4)*, 1994, at Sotheby's on 12 October 2012 for £21.3m (then the equivalent of $32.4m), much of the reaction focused on the fact that Clapton had bought the work, as one of a set of three, for $3.4m in 2001, representing an annual internal rate of return (IRR) of 23% (IRR is used across the board as an indicator of the efficiency of an investment and takes into account its initial cost). The historical average IRR for stock markets comes in at around 10%.

So on the face of it, this Richter (which set a then record for a living artist at auction) was a relatively stellar investment. However, what 23% versus 10% does not take into account is the risk of the purchase in the first place. In investment terms, this is known as an asset's risk-adjusted return and assesses question areas such as how likely was it that the work sold for less, or not at all? Do the possible returns of art make up for its possible risks in comparison with other assets? When I recently detailed the risk factors of art as an asset, outlined below, to a professional investor, he said that his required return would be at least 50%, adding 'anyone who says less than 20% needs a lesson in investment'.

LIQUIDITY, LIQUIDITY, LIQUIDITY

One of the most glaring risks of owning art is the lack of liquidity in its market. In this book, liquidity is broadly defined as the ability to sell an investment for cash (i.e. to liquidate it), with cash itself representing the most liquid asset. The greater the ability to sell an asset, the less chance that a quick or forced sale would necessitate a discount. Illiquid assets 'either take a long time to sell or the very act of selling them in a hurry sends their price into a tailspin'.[4] It is liquidity that makes the difference between something being 'worth' a certain amount and being able to realise, or even leverage, that worth. In financial terms, the 'illiquidity discount' means that investments that are less liquid generally trade for less than those that are more liquid.

A good indicator of liquidity in all markets is the difference between the 'bid' and 'ask' price (the highest price someone is willing to pay and the lowest price for which someone is willing to sell, a familiar piece of available information in the stock market, as well as in currencies and commodities). A market is illiquid when people are not willing to pay the price at which someone wants to sell. Generally, the bid price is lower than the ask. There is already a dislocation in the art market in which the closest thing to the ask price is the reserve set at auction, which is not disclosed and is always lower than any

winning bid (also, by necessity, undefined). In the art market, the notion of a work's true price is a moveable feast.

Further, the art market is controlled by relatively few powerful intermediaries, who often deliberately restrict its liquidity by, for example, creating an environment in which selling is frowned upon or keeping prime works off the market until the opportunity suits. As the pioneering art-market economist William Grampp observed in 1989, 'the market for art is not efficient in the way the market for securities [shares] is efficient. There is no reason to believe it should be, because the cost of making it so would probably be greater than the gain.'[5] Controlling the market's supply in part keeps the intermediaries in business.

An important relative characteristic of the art market, which has some bearing on its illiquid status, is that it is eye-poppingly small. In general, the bigger the market, the more liquid it will be as the impact of each trade is relatively reduced. In 2009, the *Skate's Art Investment Handbook* (which acknowledges that its data collection is something of a 'broad brush') estimated that the entire number of unqualified works of art in existence (a total of between 70m and 150m) was worth between $4tn and $6tn. Of this, less than 1% – around $400bn – is available on the market (the rest are 'closely held by museums around the world'). At the time of writing, the market capitalisation (value) of the multinational Apple alone was $425bn.

According to Skate's, an estimated 500,000 works get added each year, most of which go into free float on the market, as new works (that operate in what is known as art's 'primary market') are less likely to go straight into a museum's collection.[6] The works that sell generate (at best) around $60bn of annual turnover. By comparison, the over-the-counter gold-market turnover was assessed at around $60tn at the end of 2011 (the London Bullion Market Association found that $34.7bn was traded in gold in London in the month of March 2013 alone); the global equity (stock) market was estimated at around the same level in the same year ($63tn of electronic order-book turnover, according to the World Federation of Exchanges). But the dollar value

of daily trades is by no means a deterrent to a healthy market. The only market addressed in this book that is smaller than art (by some degree) is the global wine market: Liv-ex, which operates the go-to wine indexes, values this at around $4bn of trades a year. Here, the biggest difference is the volume of identical products that come onto the wine market versus art's largely unique output.

The art market's size is one of the things that has worked against art funds – the attempt to improve liquidity by pooling outside investment to acquire works. Philip Hoffman, who heads The Fine Art Fund Group, tells the story of one institutional investor who wanted to put $2bn into his first fund, which represented around 80 times its total value at the time.[7] Despite the self-serving nature of this story, it does also illustrate an important point. Institutional investors, who allocate their large funds in percentage terms, are most likely thrown at the first hurdle in the art market.

REGULATION

Another risk factor to consider in any market is the structure in place (or otherwise) to oversee its activity. Lack of regulation in the art market is one area that is often cited as preventing serious investment. In the public-equity market, for example, basic information such as how much stock an investor holds relative to the asset he is buying must be disclosed, and independence must be legally established for businesses or individuals who recommend investment in certain stocks (share-tipping). Insider trading, where individuals with access to non-public information profit from it, is illegal in several countries. Also illegal is the related practice of 'front running', where an intermediary buys stock that it is soon to market externally, thus benefiting from – again – proprietary information and the price that is then set by its purchase.

The equivalents of such practices are not only prevalent in the art market, they are its accepted behaviour. For example, dealers regularly bid at auction on works by the artists that they represent, adding a

public value to their stock. This is general practice and there is no requirement for this to be disclosed to the other auction participants, who most likely have no idea that they are bidding against someone with a vested interest in pushing prices up. Intermediaries also have the option to conduct their bidding completely anonymously – via the telephone or by an absentee bid, for example. Both the buyer and the seller of works remain anonymous, unless they wish to make themselves public (which they rarely do).

One of the most distorting practices in the art market – so prevalent it is largely ignored – is that of including the buyer's premium (up to 25%) in official auction results but not in the pre-sale estimates and then comparing the one to the other as a measure of success. This daily process, while universally accepted, is at best absurd, at worst highly misleading.

While other efficient markets are relatively lightly checked (such as wine and even the gold market) they still operate a robust system of self-regulation. The art market's endemic opacity (of which more below) is something that prevents effective regulation, which struggles to keep pace in bigger and more open industries, even getting off the ground. In addition, in a market that has its fair share of fakes and forgeries, important areas such as authentication often end up in the realm of subjective opinion, on which even the greatest experts can't agree. It is difficult to imagine an overseeing body that could overcome such prevalent uncertainties.

Further, regulation tends to enter the scene after a market has widened and deepened its interest to more of a mass market. While the visible art market remains the preserve of a wealthy few, there is little impetus to establish any form of protective oversight. The law courts have proved the only place to resolve conflicts, and suits are on the increase. The only area that seems to have raised governmental flags in recent years has been money laundering, with purchases such as chateaux in Bordeaux, prime property and high-end art increasingly looked at in this context. For those who want to buy and sell at lower

levels – in reality the bulk of the market – there is little or no protection in place and investors are understandably alarmed.

CORRELATION

A market that is uncorrelated to other markets (that is, goes in the opposite direction) presents an attractive investment opportunity. Buying a 'put option' to sell a specific amount of a stock-market holding at a fixed price within a specified time offers the security of mitigating exposure to that asset.

Many investors justify their holdings in art based on its relationship with other assets in their portfolio. This is a core tenet of 'Modern Portfolio Theory' (MPT), a term that mathematically underpins asset investment today. MPT was coined by the Nobel Prize-winning professor Harry Markowitz and is expanded upon in his 1991 book, *Portfolio Selection*. Here he demonstrates how the best-performing portfolio of assets is one that is diversified, with both risk and reward balanced out. His theory demonstrates that even if different assets have a correlated relationship, their risk is diminished by the joint exposure.

In this context, investors find that art plays an important role. Most believe that it is negatively correlated to the stock market, protecting from the latter's downside by operating in the opposite direction. This was exacerbated through the 2008 financial market crash when several art-market auction records were set against a backdrop of economic gloom.

Art's lack of correlation is, however, not entirely convincing. The art market as a whole crashed at the same time as the stock market in 2008, with only the top-priced works recovering. The price levels for art will always reflect the fortunes of its buyers, and the wealthiest few have emerged relatively unscathed from the credit crisis, which part explains the auction records (a correlation with wealth rather than with fundamental characteristics). Studies have shown that in fact art prices have had a strong relationship with the performance of the London Stock Exchange since the eighteenth century – showing,

at most, a slower reaction due to the art market's illiquidity. In recent years the contemporary market in particular seems to have been directly linked to the performance of equities. Plus, says Greg Davies, the head of behavioural finance and investment philosophy at Barclays, the data frequency to support such a claim is much too short to be meaningful, given art's illiquidity.[8] What may seem to be a lack of correlation may in fact be a lack of transparency. But it is certainly true that art's unique, erratic and sometimes baffling performance as an asset does at least offer the potential to change the mix, sometimes acting as a hedge to other investments.

A related risk factor is art's hard-asset qualities, which have been marketed by its traders through the credit crisis. In times of trouble, visible assets, such as gold, property and currencies, with an intrinsic value (however debatable) become more attractive than intangible 'on-paper' investments. This is largely because they offer a seemingly secure hedge against inflation (this is certainly the investment case for gold), but, again, the patchy data available for art, and the often irrational determinants of its value, suggest applying the same rationale with any certainty may be a stretch.

The increased attention that assets such as gold and art have attracted since the credit crisis also reflects the increasingly limited market. The supply of all available assets has shrunk considerably. Matt King, a credit product strategist at Citi Research, calculates that, for example, the net supply of US fixed-income products (including Treasury notes and corporate bonds) fell from around $2tn in 2006 to around $250bn in 2012.[9] The price of gold – another so-called hard asset – rallied during the credit crisis and, perhaps more surprisingly, equities (or stocks and shares) have also benefited from the reigned-in supply of other assets.

THE OTHER SIDE OF THE EQUATION

The above list of risk factors is not exhaustive, but presents some of the concepts that are developed more anecdotally within each chapter

of this book. In theory, however, they should be balanced out by the returns that art can offer. In reality, even assessing these returns presents another risk factor: the market's lack of transparency.

The greatest hurdle to any relative assessment of art's real returns is a chain of limited and often subjective information that renders itself almost meaningless by the time it is collated. The strongest link in the shaky chain is in the form of the sale results from auction, boosted with their sale commissions. Even this, at best half-the-necessary data, seems to be shrinking in proportion to the whole market as auction houses expand their private-sales business and most of the new, online auctioneers do not release any sales figures.

These results are also inconsistent in themselves: for example, most reported prices include the buyer's premium, but this is not always the case; some works are sold at charity auctions, which distort the recorded prices paid; sales are recorded but often don't complete for works deemed of national importance; and so forth. Then, once the data points are collated, they are presented in a variety of ways: some indexes account for inflation, others don't; some account for individual artists, others group according to (already blurry) sub-market definitions; some try to take into account art's 'unique' status, by separating out definable qualities such as size, colour or date (the latter not always available), or more subjective data such as the importance of a work within an artist's oeuvre or the relative impact of its provenance. Nothing as yet can take into account factors such as the impact of the pre-sale estimate, a work's relative order in an auction, the skill of an auctioneer or facts such as for how long a work has been on the market, which are often known only to a few experts.

FACTORS affecting price

In this context, it is telling that the 'World wealth report' no longer incorporates 'Investments of Passion' (including fine art, watches, jewellery, wine, classic cars, racehorses) in its calculations of investible wealth, not even as one of its alternative assets (where it resided until 2008). The 2004 report said these had transformed, together with other alternative assets, into 'mainstream investment vehicles'.[10] By

2012 the report was more muted. Here 'Investments of Passion' were said to have 'attracted interest as a substitute investment', but it is clarified that they do 'not count toward our calculations of HNWI [high-net-worth individual] investible wealth'.[11] Their short stay in Capgemini's and RBC Management's asset-allocation data underlines their limited moment as financial product equivalents.

Looked at this way, the returns that should mitigate the art market's risk factors instead epitomise one of its greatest inefficiencies.

THE SPECTRUM OF LIQUIDITY

The following chapters have been ordered from the most liquid market assessed to the least, beginning with public equities (also known as stocks or shares), the most traditional asset addressed. Gold comes next, which, like equities, is a homogeneous product, but unlike these has no underlying, producing business and so generates no income. It is a tangible asset that can simply go up or down in value. But it is, based on its status as a reserve asset, a liquid investment, traded as a commodity that can instantly be turned into money for a fixed price. Wine then follows, as the most liquid of all the alternative assets and an example of an investment of passion that has been able – to a certain extent – to monetise some of its increased appeal as an investment. The prime-property market is an example of how an asset where no unit is identical can render it illiquid, despite a high volume of turnover, hence it falls into the second half of this book. Private equity is the last asset that is compared directly to art, with which it shares its longer-term, trust-the-experts investment characteristics, as well as being the model on which art funds – unproven (at best) attempts to monetise gains in the art market – were initially based.

The final chapter, which looks at the luxury-goods market, is more tangential as it compares art with goods (such as branded clothes) that are not treated as assets, although they underpin a thriving global market. This serves a dual purpose. Primarily it demonstrates the fact that much

contemporary art (that is, art by living artists) should not be seen as an investment per se and is instead better understood as a product along the same lines as luxurious fashion items. This is not, by comparison, to rob art of any of its aesthetic properties, but to take out the historical, heritage values that others have sought to overlay on even the newest art, thus arguably manipulating (or at best distorting) the market.

The other reason to look at the fashion industry is to show how contemporary art *could* turn itself into a more predictable, asset-based business – and the challenges it might face in trying. This would mean that profits would not be limited to one work, or a small group of works, going up in perceived value, but could instead come from the high volume and mass-market potential of the contemporary-art market, where there is untapped demand and unlimited supply. While this would likely mean unit costs coming down to what is arguably closer to contemporary art's true worth, it could also pave the way to encouraging external funds into a more visible and stable industry.

The chapter ordering is debatable on several levels – and there are, of course, other assets that could have been included, whether traditional (fixed-income products, including bonds), other alternative assets (hedge funds, silver) or other investments of passion (coins, classic cars). Those chosen seemed to have the most relevance to art, either because of their own distinct qualities or because they have been used more frequently as points of comparison. Further, at any point in time the spectrum of liquidity could be shaken up – one art-fund manager points out that there are often more people interested in one work of art than in one piece of prime property. But the basic separation – half liquid assets, half illiquid – stays true.